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No. 97-877

In the Supreme Court of the United States

OCTOBER TERM, 1997

ELIZABETH R. COCKRELL, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a taxpayer is entitled to "innocent spouse" relief from joint and several income tax liability under Section 6013(e) of the Internal Revenue Code, 26 U.S.C. 6013(e), when she signed joint federal income tax returns without reading them or enquiring as to the substantial "commodity straddle loss" deductions claimed on them.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-4a) is unreported. The opinion of the Tax Court (Pet. App. 28a-40a) is reported at T.C. Memo. 1993-503, 66 T.C.M. (CCH) 1180. The supplemental opinion of the Tax Court (Pet. App. 7a-27a) is reported at T.C. Memo. 1995-551, 70 T.C.M. (CCH) 1374.

JURISDICTION

The judgment of the court of appeals was entered on June 24, 1997. On September 2, 1997, Justice Ginsburg extended the time to file a petition for a writ of certiorari to and including November 21, 1997. The petition for a writ of certiorari was filed on

November 21, 1997. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a college-educated Canadian citizen and former life insurance agent. In 1979, she married a United States citizen named John Crowley (Pet. App. 4a, 10a-11a, 20a, 23a, 31a). Crowley was a partner in several partnerships that engaged in commodity straddle transactions involving Treasury bill options (*id.* at 11a, 32a). Petitioner was aware that Crowley was a commodities trader (*id.* at 12a, 20a, 32a). She accompanied him to commodities seminars and tried to help him attract clients to his business (*id.* at 4a, 12a, 20a, 32a-33a). Petitioner testified, however, that she did not understand the nature of the business and never discussed commodities straddle transactions with Crowley (*id.* at 12a; C.A. App. 221-222, 262-263). In December 1980, petitioner was hired as a stockbroker trainee. In early 1981, she obtained her broker's license (Pet. App. 4a, 11a, 20a, 23a, 32a).

Petitioner and Crowley filed joint federal income tax returns for 1980 and 1981 on which they claimed sizable deductions for losses resulting from Crowley's commodity straddle transactions (Pet. App. 3a, 12a-13a, 18a-19a, 33a). Petitioner stated that she signed both returns without first reviewing them (*id.* at 3a, 13a, 17a-18a, 23a). She further testified that she had not discussed the returns either with Crowley or with Robert K. Kraft, a tax advisor who worked for petitioner's employer and who assisted Crowley with the 1981 return (*id.* at 3a, 19a; C.A. App. 100, 223, 224-228).

By August 1983, petitioner and Crowley were divorced (Pet. App. 12a, 33a). The Commissioner of Internal Revenue determined deficiencies in the 1979, 1980 and 1981 income tax returns of petitioner and Crowley. The deficiencies resulted primarily from disallowance of the deductions claimed for the losses from commodity straddle transactions (*id.* at 13a, 29a, 33a).

2. Petitioner and Crowley sought review of the asserted deficiencies in Tax Court. They settled the underlying deficiencies pursuant to the terms offered to all taxpayers who had been engaged in similar straddle transactions (Pet. App. 13a-14a, 30a, 34a). The settlement, however, left open the issue whether petitioner was entitled to "innocent spouse" relief for 1980 and 1981 (*id.* at 30a).

Spouses who file joint federal income tax returns are normally jointly and severally liable for the full amount of tax due on their combined incomes. 26 U.S.C. 6013(d)(3). If a spouse can satisfy the requirements of 26 U.S.C. 6013(e), however, she can be relieved of liability for tax deficiencies due to the erroneous tax items of the other spouse. A spouse is entitled to "innocent spouse" status if she can demonstrate (i) that a joint return was filed for the year at issue; (ii) that the return contained a substantial understatement of tax due to the grossly erroneous items of the other spouse; (iii) that in signing the return she did not know or have reason to know of the understatement; and (iv) that it would be inequitable to hold her liable for the understatement. 26 U.S.C. 6013(e). A taxpayer must satisfy *all* of these requirements to be entitled to innocent spouse status.

The Tax Court rejected petitioner's contention that she was entitled to innocent spouse relief (Pet. App. 39a-40a). The Tax Court noted that a taxpayer seeking innocent spouse status must introduce evidence—beyond the mere disallowance of the deduction—to establish that the deduction is "grossly erroneous" (26 U.S.C. 6013(e)). The court found that petitioner had not offered such evidence in this case (Pet. App. 37a-39a). Because petitioner had failed to satisfy that component of the test for innocent spouse status, the Tax Court did not address the other statutory prerequisites for such relief (*id.* at 8a n.4, 36a-40a).

On petitioner's motion for reconsideration, the Tax Court issued a supplemental opinion in which it found, as an additional ground to deny innocent spouse relief, that petitioner had "reason to know" of the substantial understatements (Pet. App. 7a-27a).[1] The court emphasized that petitioner should have realized that she was responsible for reviewing the returns before signing them (*id.* at 17a-18a, 22a-23a): she was well educated; she was involved in her husband's financial affairs; she enjoyed a comfortable standard of living; and she had produced no evidence that Crowley was evasive or deceitful about the family finances or that he concealed information from her (*id.* at 18a-23a). The Tax Court found that (i) the deductions on the returns were of sufficient magnitude to give rise to a duty to enquire as to their

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[1] Petitioner errs in stating that the Tax Court withdrew its first ruling (Pet. 8 n.5, 24). In issuing its second opinion, the Tax Court stated that, given the state of the record, it "need not reconsider the holding of our prior Opinion" (Pet. App. 7a n.*, 14a-15a).

propriety and (ii) petitioner had failed to fulfill that duty (*id.* at 18a-19a). The Tax Court concluded that innocent spouse status is unavailable in this case because 26 U.S.C. 6013(e) "is designed to protect the innocent, not the intentionally ignorant" (*id.* at 19a).

3. The court of appeals affirmed in a brief, unpublished order (Pet. App. 1a-4a). The court concluded that the deductions on the returns were so substantial that a duty to enquire as to their validity necessarily arose (*id.* at 3a). "Yet, despite this indication that the tax returns might contain substantial understatements, [petitioner] took no steps to fulfill even the most minimal duty to enquire as to the propriety of the tax shelter deductions. She failed to ask her husband or anyone else about the legality of the deductions they claimed." (*Ibid.*) (internal quotation marks omitted). The court of appeals noted that petitioner was educated, that she was (at least in a limited way) involved with Crowley's business, that the couple lived "lavishly," and that there was no evidence that Crowley was evasive or deceitful about the couple's finances or about the commodity straddle deductions (*id.* at 4a). The court concluded that there were ample grounds for the Tax Court to find that petitioner had "reason to know" that the deductions would give rise to substantial understatements and that she was therefore not entitled to innocent spouse relief (*ibid.*).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Husbands and wives can generally lower their federal income tax liability by filing a joint income tax return rather than separate returns. For such filers, the progressivity of the tax rates is eased by doubling (compared to spouses filing separate returns) the amount of income subject to tax in each bracket. See 26 U.S.C. 1. The price exacted for that privilege is that spouses who file joint returns normally are jointly and severally liable for the full amount of tax due on their combined incomes. 26 U.S.C. 6013(d)(3). Joint and several liability may be avoided under the "innocent spouse" provision only if the spouse demonstrates, among other requirements, that she neither knew nor had reason to know that the return contained a substantial understatement of tax attributable to the grossly erroneous items of the other spouse. 26 U.S.C. 6013(e)(1)(B) and (C).

Although, as a remedial statute, 26 U.S.C. 6013(e) is applied liberally in favor of the person claiming its benefits (*Friedman* v. *Commissioner*, 53 F.3d 523, 528-529 (2d Cir. 1995)), it is also true that Congress provided only a narrowly defined "innocent spouse" exception from joint liability. *Park* v. *Commissioner*, 25 F.3d 1289, 1293 (5th Cir.), cert. denied 513 U.S. 1061 (1994). As the Tax Court correctly explained, joint and several liability is "an important adjunct to the privilege of filing joint returns, and . . . if there is to be any relaxation of that rule [of joint liability] the taxpayer must comply with the carefully detailed conditions set forth in section 6013(e)" (Pet. App. 27a n.18, quoting *Sonnenborn* v. *Commissioner*, 57 T.C. 373, 381 (1971)).

2. Petitioner errs in asserting (Pet. 10-16) that the decision in this case conflicts with decisions of other circuits. Innocent spouse cases are inherently fact-

specific (*Hayman* v. *Commissioner*, 992 F.2d 1256, 1260 (2d Cir. 1993); *Guth* v. *Commissioner*, 897 F.2d 441, 443 (9th Cir. 1990)), and an examination of the cases relied on by petitioner demonstrates that the courts have applied the same legal analysis to the unique facts of each case.

a. In cases involving erroneous deductions, the Second Circuit has adopted the analysis set forth by the Ninth Circuit in *Price* v. *Commissioner*, 887 F.2d 959 (1989). See *Friedman* v. *Commissioner*, 53 F.3d at 530-532; *Hayman* v. *Commissioner*, 992 F.2d at 1261. The court in *Price* stated that a duty of enquiry arises when the taxpayer who seeks innocent spouse relief "knows sufficient facts such that a reasonable prudent taxpayer in her position would be led to question the legitimacy of the deduction." 887 F.2d at 965. A failure to fulfill that duty therefore "may result in constructive knowledge of the understatement being imputed to her." *Ibid.* See also *Reser* v. *Commissioner*, 112 F.3d 1258, 1267-1268 (5th Cir. 1997); *Resser* v. *Commissioner*, 74 F.3d 1528, 1535-1543 (7th Cir. 1996); *Kistner* v. *Commissioner*, 18 F.3d 1521, 1525 (11th Cir. 1994); *Erdahl* v. *Commissioner*, 930 F.2d 585, 589-591 (8th Cir. 1991); *Guth* v. *Commissioner*, 897 F.2d at 443-445; *Stevens* v. *Commissioner*, 872 F.2d 1499, 1505, 1507 (11th Cir. 1989). The presence on a return of deductions that are large in comparison to a couple's income may place a spouse on notice that further enquiry is warranted. *Reser* v. *Commissioner*, 112 F.3d at 1267-1268; *Friedman* v. *Commissioner*, 53 F.3d at 531; *Hayman* v. *Commissioner*, 992 F.2d at 1262; *Price* v. *Commissioner*, 887 F.2d at 965-966; *Stevens* v. *Commissioner*, 872 F.2d at 1507. Courts have also agreed that, in assessing the claimed "innocent

spouse" defense of a taxpayer, a court should consider her education, her involvement in family financial affairs, the presence of expenditures that are lavish or unusual compared to the family's prior financial status, and the other spouse's evasiveness or deceit in family financial matters.[2] *Price* v. *Commissioner*, 887 F.2d at 965. See *Reser* v. *Commissioner*, 112 F.3d at 1267; *Resser* v. *Commissioner*, 74 F.3d at 1536; *Kistner* v. *Commissioner*, 18 F.3d at 1525; *Erdahl* v. *Commissioner*, 930 F.2d at 590-591; *Guth* v. *Commissioner*, 897 F.2d at 444; *Stevens* v. *Commissioner*, 872 F.2d at 1505.

The differing results reached in innocent spouse cases turn on the particular facts of each case, not on differing interpretations of the applicable law. In some of the cases cited by petitioner, the courts concluded that the wife fulfilled her duty to enquire. Compare *Resser* v. *Commissioner*, 74 F.3d at 1541-1543 (wife questioned transactions and was assured by husband of their legitimacy; no duty to "re-enquire" at time of signing return); *Price* v. *Commissioner*, 887 F.2d at 966 (wife questioned husband and received reassurances prior to signing return), with *Stevens* v. *Commissioner*, 872 F.2d at 1507 (wife had doubts regarding return but blindly signed anyway; innocent spouse status denied). In others, it was determined that the wife lacked a meaningful reason or opportunity to enquire. *Kistner* v. *Commissioner*, 18 F.3d at 1526-1527 (husband denied wife access to financial records and threatened violence if she questioned returns); *Pietromonaco* v. *Commissioner*,

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[2] Contrary to petitioner's suggestion (Pet. 12 n.6), in *Hayman* v. *Commissioner*, 992 F.2d at 1261, the Second Circuit merely followed *Price*. It did not formulate a new test.

3 F.3d 1342, 1344-1347 (9th Cir. 1993) (omitted income case, husband was evasive and controlled business affairs, lifestyle and spending patterns were insufficient to place wife on notice of omitted income from husband's business); *Guth* v. *Commissioner*, 897 F.2d at 444-445 (husband hid information; wife was insufficiently aware of unusual nature of transactions to trigger duty of inquiry).

In the present case, petitioner is a college-educated stockbroker and former life insurance agent who testified that she did not review her joint returns prior to signing them (Pet. App. 3a-4a, 11a, 13a, 17a-18a, 20a, 23a). Those returns contained sizable deductions for commodity straddle losses ($407,884 in 1980 and $679,327 in 1981) (*id.* at 3a, 12a-13a, 18a-19a, 33a). Petitioner testified that she never discussed the commodities straddles with Crowley and did not discuss the returns with either Crowley or Kraft, who worked at her office (*id.* at 3a, 12a, 19a; C.A. App. 100, 221-223, 224-228, 262-263). There was no evidence that Crowley was evasive or deceitful regarding the couple's finances (Pet. App. 4a, 20a-21a, 23a). The Tax Court correctly held that petitioner is not entitled to innocent spouse status simply because she remained willfully ignorant of substantial deductions on the couple's joint returns (*id.* at 3a-4a, 17a-19a, 22a-23a, 26a). Other courts have similarly concluded that innocent spouse status is not appropriate in such circumstances. See, *e.g.*, *Friedman* v. *Commissioner*, 53 F.3d at 525; *Erdahl* v. *Commissioner*, 930 F.2d at 589; *Price* v. *Commissioner*, 887 F.2d at 965-966. See also *Stevens* v. *Commissioner*, 872 F.2d at 1507.

b. Petitioner errs in asserting (Pet. 10-12) that the decision in this case conflicts with the decision of the

Fifth Circuit in *Reser* v. *Commissioner*, 112 F.3d at 1269. Mrs. Reser was a personal injury attorney married to the sole shareholder of a corporation that had elected to be taxed under subchapter S of the Internal Revenue Code. That corporation had losses of $257,354. *Id.* at 1260-1261. The income of subchapter S corporations is normally passed through and taxed directly at the shareholder level; losses of such corporations, however, are passed through and deductible by shareholders only to the extent of their basis in the corporation. *Id.* at 1263-1264. When she signed the 1987 joint return, Mrs. Reser thought that she and her husband had invested sufficient funds in the S corporation to cover the losses from the corporation that they deducted on their return for that year. *Id.* at 1268. As it turned out, however, the Resers had an insufficient basis in the corporation to allow them to use the loss deductions, and a large joint income tax deficiency therefore resulted. *Id.* at 1261-1265.

On the particular facts of that case, the Fifth Circuit held that Mrs. Reser was entitled to innocent spouse status. 112 F.3d at 1272. The court explained that Mrs. Reser did not have a duty to enquire into the correctness of the basis assumption for two reasons. *Id.* at 1269. First, the court stated that her case was "not the typical 'dramatic deductions' case" because, given Mrs. Reser's knowledge of the finances of the S corporation, there was nothing surprising to her about the large loss deductions on the return. *Ibid.* Second, the court stated that Mrs. Reser had no duty to make further enquiries because "any further inquiry would have been informatively futile under the discrete facts of this case." *Id.* at 1269, 1272. The court explained that the propriety of

the loss deductions turned on a "hypertechnical determination" regarding whether Mr. Reser or the corporation had borrowed certain funds and that the professionals involved in preparing the joint return had a genuine (if incorrect) belief that the loss deductions were correct. *Id.* at 1269.

The "discrete facts" on which the court relied in *Reser* plainly make that decision distinguishable from the present case. While Mrs. Reser was found to have a reasonable expectation that the joint return would contain large deductions, petitioner had no similar basis for any such assumption (Pet. App. 3a, 12a-13a, 19a; C.A. App. 100, 221-223, 224-228, 262-263). Indeed, if, as petitioner asserts, she was uninformed as to the details of her husband's business, the large deductions on the returns should have put her on notice that something highly unusual must have occurred with respect to their financial situation. That sort of unusual financial development is precisely the sort of fact that, under the consistent holdings of the courts of appeals, triggers a duty of further enquiry on her part. See page 7, *supra*.[3]

The distinction between these decisions thus rests upon the differences in their underlying facts. These factual differences in the application of the applicable legal test for "innocent spouse" relief do not warrant

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[3] Further, in *Reser* there was "no doubt" that, if Mrs. Reser had asked further questions, she would have been informed by the professionals who prepared her return that the deductions were correct. 112 F.3d at 1269. Petitioner, by contrast, has offered only the supposition that Crowley would have informed her that the commodity straddle deductions were legitimate (Pet. 11-12, 17). In the Tax Court, however, she failed to adduce any evidence on that issue. (See Pet. App. 4a, 20a-21a.)

review by this Court. The decision in the present case would, in any event, be an unsuitable vehicle for review of the asserted conflict, for the denial of the "innocent spouse" defense in this case rests upon the additional ground that the commodity straddle loss deductions were not "grossly erroneous," as the statute requires. See page 4, *supra*.[4]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[4] Moreover, as petitioner notes (Pet. 19-22), legislation is pending in Congress that could alter the scope of the "innocent spouse" statute. The issue that petitioner seeks to frame for review therefore has only an uncertain prospective importance.